Credit ratings and capital structure decisions

Panel discussion “Capital structure – where do we stand and where are we heading?”

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Why are ratings important for corporate decision makers?

- Virtually all firms with public debt nowadays have one or more external ratings
- Many firms seem to
  - target an explicit rating level
  - maintain a certain threshold rating
- To maintain or to achieve a certain rating, companies change their capital structure directly by issuing equity or buying back debt
- Others try to strengthen their balance sheets through asset sales or dividend cuts
- Firms seem to *trade off* benefits of debt financing versus having a higher/better credit rating
- Apparently, firms believe that credit ratings can affect shareholder value
Credit ratings and shareholder value

- Maintaining a particular credit rating provides several potential benefits to a company
  - Access to commercial paper markets
  - Access to a broader set of investors
  - Lower disclosure requirements
  - Improved third-party relationships
  - Signaling of firm quality

- Certain rating actions may also trigger other (negative) events because of bond covenants
  - Increase in coupon rates
  - Loss of contracts
  - Required repurchases of bonds
Credit ratings and optimal capital structure

Since a company’s leverage affects its credit rating, the benefits or having a better rating are relevant for determining a firm’s optimal capital structure.

Example:
- For instance, according to the trade-off theory, the optimal capital structure might be achieved with a leverage of 55%.
- However, to achieve a better rating, the firm would have to reduce leverage to 50%.
- In this case, it may be optimal for the firm, to have a leverage of 50% although the trade-off theory would indicate 55%.
- Benefits of having a better rating would outweigh the benefits of having an optimal capital structure as suggested by the trade-off theory.
Empirical evidence on the influence of credit ratings on capital structure

- A study by D. Kisgen ("Credit ratings and capital structure", JF, 2006) finds that
  - Companies near a rating change take steps towards avoiding a rating downgrade or achieve an upgrade
  - Companies that are more likely to have a rating change are more likely to reduce leverage than other firms
  - Effects are most pronounced at the investment/non-investment grade threshold
  - Firms that rely on commercial paper issuances are also more affected because they might lose the access to commercial paper markets

- Another study by D. Kisgen ("Do firms target credit ratings or leverage levels", JFQA, 2009) finds that
  - After a rating downgrade, companies are more likely to reduce debt, and less likely to issue debt or repurchase stock
  - Effect is stronger if the downgrade was to non-investment grade

- Conclusion: credit ratings seem to be very important for capital structure decisions and more research in this area is needed